IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1942.

No. 189

FRANK A. BARLOW, TRUSTEE OF THE ESTATE OF THE LIBERTY POSTER COMPANY, A CORPORATION, BANKRUPT, *Petitioner*,

vs.

W. P. BUDGE, CLAIMANT,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Your petitioner, FRANK A. BARLOW, trustee of the estate of the LIBERTY POSTER COMPANY, a corporation, bankrupt, in support of the petition for Writ of Certiorari, to be directed to the United States Circuit Court of Appeals for the Eighth Circuit, to review a judgment rendered on the 20th day of April, 1942, which affirmed the judgment of the United States District Court for the District of Minnesota, Fourth Division, dated December 31, 1940, which affirmed the order of the Referee in Bankruptcy, allowing the claim of W. P. Budge in the sum of $4,950.00, and the District Court order, dated February 18, 1941, denying a motion for a rehearing and reconsideration of the judgment, dated December 31, 1940, respectfully shows:

A.

SUMMARY STATEMENT OF THE MATTER INVOLVED

Petitioner is the trustee of the estate of the Liberty Poster Company, who had been engaged in the printing business at Minneapolis. For several years before supervening bankruptcy, the corporation had only three stockholders, each holding one-third of the capital stock and had held no stockholders' or directors' meetings. The corporation had only two directors and officers, to-wit: W. P. Budge, hereinafter called respondent, who kept the books and signed the checks, and Charles A. Rose, who managed the plant. These two officers had the sole domination and control of the business. They operated the business in the same free manner as a copartnership or joint venture.

Respondent filed a claim against the bankrupt estate for $4,950.00 for money that he had contributed to the corporation to save it from financial difficulty and to preserve his investment. As a result of such contribution, the corporation's financial standing and reputation in the community was preserved and the corporation continued to receive credit. The Supreme Court of Minnesota holds that creditors deal with a corporation on the faith of its financial standing and reputation in the community, which in turn is based on the professed and supposed capital, although such creditors have no personal knowledge of the amount of the professed capital. If respondent had not made such contribution, the corporation would have been forced to liquidate, the general creditors, hereinafter described, would not have extended credit, would have suffered no loss and would not now be creditors of the corporation. By "General Creditors," we refer to those creditors who extended credit to the corporation after July 1, 1937, after respondent had ceased

to contribute and the only creditors whose claims had been filed and allowed. The total of the claims of these creditors is $9,182.33.

Petitioner as trustee objected to the allowance of the claim of respondent upon the following ground: The business was operated as though it were a partnership or joint venture. Respondent's claim constituted a contribution to capital. Respondent and Rose committed a fraud on the general creditors because they incurred said debts when they knew such debts could not be paid in full, especially if respondent were to compete with them for the payment of his contribution, because of the then financial condition of the corporation.

The Referee in Bankruptcy and the District Court found no disputed question of fact. There could be no disputed question of fact since the evidence was limited to the testimony of respondent and the corporate records kept by him. There are not sufficient assets to pay the claims of general creditors.

The necessity for contributions by respondent arose from unauthorized withdrawals by himself and Rose, which eventually impaired the corporate capital. The contributions were made from time to time during 1935 and 1936 without any agreement for repayment or the taking of a note or notes. For the years 1927 to 1931, inclusive, the corporation had operated at very little profit. For the years 1932 to 1934, inclusive, the corporation suffered very substantial losses. If the contribution is sustained as a debt, rather than a capital contribution, it increased the debt beyond the limit fixed by the charter. After the making of the contribution, the corporate debts continued to increase until at the time the debts to general creditors were incurred the total debt exceeded the debt limit fixed by the charter

by an amount greater than the contribution of the respondent.

The debts of the general creditors were contracted by respondent and Rose after the financial condition of the corporation had become so bad that respondent was unwilling to and did not make any further contribution. The contribution made by respondent in no way benefited the general creditors. In fact, if the contribution had not been made, the corporation would have been obliged to liquidate before it obtained credit from the general creditors. In obtaining credit from the general creditors the respondent well knew that the claims of such creditors would not be paid in full, especially if he were to compete with them for the payment of his contribution.

The referee treated the issue as one between respondent and the corporation, and since the corporation had received the money, respondent's claim was allowed. The referee failed to consider that there was any issue between the respondent and the general creditors, although the same was urged upon him. Upon review, the District Court affirmed the allowance of respondent's claim, treating the issue as being one between respondent and the corporation, although it was urged by the trustee that the issue was one between the respondent and the general creditors. The trustee made a motion for a rehearing and reconsideration of the Court's order affirming the order of the referee, urging upon the District Court that there was no disputed question of fact, that the issue was not one between respondent and the corporation but between respondent and the general creditors. That motion was overruled. An appeal was taken to the Circuit Court of Appeals, and again the trustee urged upon that Court that the issue was one between respondent and the general creditors. The Circuit Court of Appeals by a divided court, affirmed the District Court. Circuit Judge

Johnsen in a dissenting opinion said he would reverse the judgment of the District Court. The Court in the majority opinion conceded that the bankruptcy court might have subordinated the claim of the respondent to that of the general creditors, but in explanation of its failure to do so, said:

> "We hesitate to say, however, that, under the evidence, the court of bankruptcy was compelled to subordinate Budge's claim to the claims of other creditors, believing, as it did, that Budge was guilty of no fraud and of no unfairness in his dealing with the bankrupt."

In other words, the issue considered was one between respondent and the corporation and not between respondent and the general creditors. The closing paragraph of the majority opinion indicates that the bankruptcy court, although there was no disputed question of fact and although the applicable equitable principles have been well settled by this Court, might exercise its discretion as to subordinating the claim of respondent. The Court's language is as follows:

> "We think that the duty and responsibility of determining whether, under the applicable law, the claim of Budge was upon an equitable parity with the claims of other creditors was primarily that of the bankruptcy court, which was charged with the administration of this insolvent estate, and that this court would not be justified in setting aside the order appealed from unless convinced that it was clearly erroneous. We are not convinced that it was clearly erroneous."

B.

REASONS RELIED ON FOR ALLOWANCE OF THE WRIT

1. The judgment of the Circuit Court of Appeals in the case at bar is in conflict with the decisions of this Court in *Taylor vs. Standard Gas & Electric Co.*, 306 U. S. 307, 59 S. Ct. 543, 83 L. Ed. 669; *Pepper vs. Litton*, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281, and *Sampsell vs. Imperial Paper & Color Corp.*, 313 U. S. 215, 61 S. Ct. 904, 85 L. Ed. 1293, and the law and the equitable principles clearly set forth in these opinions.

2. That this petitioner has not had his day in court on a decisive issue shown to exist by the undisputed evidence, that is, the issue between the respondent and the general creditors as to whether respondent's claim should be subordinated to the claims of the general creditors. Such issue was not considered either by the referee, District Court or the Circuit Court of Appeals, although at all times urged. In the petition for rehearing the attention of the Circuit Court of Appeals was called to this issue, that is, that the Court had inadvertently overlooked it.

3. The Circuit Court of Appeals has decided an important question of bankruptcy law and administration that has not been but should be settled by this Court. That is, where the undisputed facts are sufficient under well established principles of equity as enforced in bankruptcy to require a claim of a dominant stockholder, director and officer to be subordinated to the claims of creditors, it is discretionary with the bankruptcy court as to whether such claim shall be subordinated. We respectfully submit that the holding of the Circuit Court of Appeals in the case at bar which is to the effect that it was discretionary with the bankruptcy court as to whether the claim of the respondent should be sub-

ordinated to that of the general creditors is *erroneous.*

Wherefore, your petitioner respectfully prays: That a Writ of Certiorari be issued out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Eighth Circuit, commanding said Court to certify and send to this Court a full and complete transcript of the record and all of the proceedings in this cause, to the end that said cause may be reviewed and determined by this Court, as provided by law, and that your petitioner may have such other and further relief as to this Court may seem proper and be in conformity with the law.

And your petitioner will ever pray.

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BRIEF IN SUPPORT OF THE PETITION

I.

THE OPINIONS OF THE COURTS BELOW

a. The District Court of the United States for the District of Minnesota, in which this cause originated filed an opinion which appears in the printed record at page 70.

b. The Circuit Court of Appeals for the Eighth Circuit filed an opinion on April 20, 1942, which appears in the printed record at page 82 and is reported in 127 F. (2) 440.

II.

JURISDICTION

The jurisdiction of this Court is invoked pursuant to Title 28, Judicial Code and Judiciary, Section 347, former Section 240, Judicial Code, amended.

III.

SPECIFICATIONS OF ERRORS

The Circuit Court of Appeals for the Eighth Circuit erred in affirming the order or judgment of the United States District Court for the District of Minnesota, which affirmed the order of the referee allowing the claim of the respondent.

IV.

STATEMENT OF THE CASE

Respondent filed a claim for $4,970.00, which included $20.00 as a balance on salary (R. 10). The referee disallowed the $20.00. Hence, there is no question of salary in issue. Petitioner objected to the allowance of the claim (R. 7). The evidence showed the bankrupt to be a Minnesota corporation with an authorized capital of $20,000.00, all paid in (R. 3). The charter limited debts to $10,000.00 (R. 11). The management and control of the corporation was in the same free and easy manner as in the case of a partnership or joint venture, and after 1925 under the complete domination and control of respondent and Rose. The by-laws provided for a board of directors of three, vested with control and management of the corporation (R. 11). No dividends were to be paid that would impair the capital (R. 12). Respondent, Rose, and Paulsen were re-elected directors to and including 1922 (R. 13-16). The first officers and those re-elected to and including 1922 were Rose, president, Paulsen, vice-president, and respondent, secretary and treasurer (R. 12-16). No stockholders' or directors' meetings were held from July 18, 1922, until July 19, 1938, when R. E. Morrissey became a director (R. 35-37). Morrissey was at all times inactive (R. 35). In 1925, Paulsen sold his capital stock to respondent, Rose, and Morrissey (R. 37), and by virtue of the by-laws ceased to be a director or officer (R. 12). While Rose was paid a regular wage for managing the business (R. 35), he also made unauthorized withdrawals at irregular intervals, including $3,030.00, after the capital was impaired (R. 18, 21). Of this sum, $2,020.00 was withdrawn during the time that respondent was contributing to the corporation. The unauthorized withdrawals were made by

checks signed by respondent. Hence, respondent was a party to such unauthorized withdrawals. Respondent kept the books of the corporation, had sole charge of its finances, signed all checks and at all times had complete knowledge of the finances, assets, business and affairs of the corporation (R. 39). Respondent's contributions were made as follows: $3,450.00 in 1935, $1,000.00 in 1936 and $500.00 February 25, 1937 (R. 10). These contributions were made at irregular intervals to prevent the bank account from being overdrawn (R. 23-27) and to save the business (R. 38). No arrangement as to repayment was made (R. 38-39). These contributions were made in the same manner a partner or joint venturer would contribute to the capital investment, as more fully appears from the account with respondent on the books of the corporation (R. 17-18). The total net profits for the years 1927 to 1931, inclusive, were $665.52. The total losses for the years 1932 to 1936, inclusive, were $8,750.75. On January 1, 1937, the capital had been impaired to the extent of $2,926.63, and the total debt, excluding respondent's claim was $6,280.14. If respondent's claim was a debt, the total indebtedness was $11,250.14, or $1,250.14 in excess of the debt limit fixed by the charter. The assets and liabilities, profit and loss, and gross sales for the years that the corporation was in business appears in tabulated form at page 21 of the printed record. The above facts give the situation on July 1, 1937. The debts of the general creditors were contracted after that date. Respondent made no contributions after that date. On that date, respondent owned one-third of the capital stock and his contribution of $4,950.00 to the capital investment. The respondent knew that although the capital had been impaired, that because of his contribution, the financial standing and reputation of the business in the community had not been impaired and that credit would be extended to the

business on that financial standing and reputation. While respondent was not willing to make further contributions, he did obtain credit from the general creditors for the business in which he was largely interested. Respondent knew from the past experience of the business, that, to say the least, there was little prospect that the business could be profitably continued. He also knew that if the business failed and he were to compete with the creditors whose debts were contracted after July 1, 1937, for the payment of his contribution, that such creditors could not be paid in full.

The referee, Walter H. Newton, allowed respondent's claim on April 9, 1940 (R. 47), because the corporation received and used the money (R. 46). A petition for review was filed April 15, 1940 (R. 53), claiming, among other errors, that the allowance of the claim and permitting it to participate in a dividend would be inequitable and a fraud upon creditors whose debts were, because of claimant's acts and conduct, contracted after July 1, 1937. The District Court, the Honorable Matthew M. Joyce sitting, affirmed the referee on December 31, 1940 (R. 70). The trustee filed a motion for a rehearing of this order on January 10, 1941 (R. 74), upon the ground that the Court had inadvertently overlooked the fact that over $9,000.00 of the indebtedness of the bankrupt was incurred after July 1, 1937, and that to permit the claimant to participate in a dividend with such creditors would be inequitable, if not fraudulent. The District Court entertained the motion for rehearing and denied it February 18, 1941 (R. 74). A notice of appeal was filed March 20, 1940 (R. 75), appealing from the order of December 31, 1940, as to which a motion for rehearing had been made and denied (R. 75). The Circuit Court of Appeals on April 20, 1942, by a divided court affirmed the lower court (R. 92). The majority opinion was written by the Honorable John B. Sanborn, Circuit Judge, and con-

curred in by the Honorable Gunnar H. Nordbye, District Judge of Minnesota (R. 82). The Honorable Harvey W. Johnsen, Circuit Judge, wrote a dissenting opinion (R. 88). A petition for rehearing was filed May 4, 1942 (R. 93), and denied May 11, 1942 (R. 105). The petition for rehearing called the Court's attention to the fact that it had inadvertently overlooked the issue between the respondent and the general creditors.

V.

ARGUMENT

1.

The Decision of the Lower Court Is Apparently in Conflict With the Decisions of This Court in That Its Failure to Subordinate the Contribution of Respondent to the Claims of the General Creditors Is Contrary to the Cardinal Principles of Equity Jurisprudence Applicable Between a Dominating and Controlling Stockholder and Director and Creditor, as Laid Down by This Court.

In *Pepper vs. Litton, supra*, this Court pointed out the cardinal principles of equity jurisprudence applicable to the disallowance or subordination of the claim of dominating officer or stockholder substantially as follows: That an officer or dominating stockholder is a fiduciary. That the standard of fiduciary obligation is designed to protect creditors as well as stockholders. That so-called loans or advances of dominating or controlling stockholder will be subordinated to the claims of other creditors and treated in effect as a capital contribution where the allowance would not be fair and equitable. That at times the debtor corporation will be treated as a part of the stockholder's own enterprise consistently with the course of conduct of the stockholder.

In the case at bar, respondent was a dominating and controlling stockholder and director. The business was conducted as though it were the enterprise of the respondent and Rose. To permit respondent to participate in a dividend with those creditors whose claims were contracted by him after July 1, 1937, considering the then condition of the corporate finances and respondent's interest in the business, would not be fair and equitable.

The lower court appears to have affirmed the District Court because the District Court held there was no unfairness in respondent's dealings with the corporation. The conduct of respondent in contracting debts after July 1, 1937, was not considered important. This is evidenced by the Court's language setting forth appellant's contentions (R. 85), which, however, omitted any reference to the contention relative to contracting debts after July 1, 1937. The Court said that appellant's contentions were not without merit (R. 85). The Court also said that it thought that the referee and the court below could have subordinated the claim of respondent to other creditors on a finding that his informal and irregular conduct of the affairs of the bankrupt had prejudiced their rights and was a violation of his duty toward them (R. 86). The Court's reason for not reversing the lower court appears in the following language taken from the printed record, page 86, to-wit:

> "We hesitate to say, however, that, under the evidence the court was compelled to subordinate Budge's claim to the claims of other creditors, believing as it did, that Budge was guilty of no fraud and of no unfairness in his dealings with the bankrupt."

2.

This Petitioner Has Not Had His Day in Court on the Issue Between the Respondent and the Creditors Whose Debts Were Contracted After July 1, 1937.

This reason is based on the failure of the referee, District Court and Appellate Court to consider that there was such an issue. This issue is bottomed upon the fiduciary obligation of the respondent as a dominant and controlling stockholder, director, officer, owner of one-third of the capital stock and a very substantial claim for contribution, to contract such debts, knowing when he did so that the claims of such creditors would not be paid in full, especially if he were to compete with them for the payment of his claim for contribution.

The only instances in which it might be remotely claimed that the Appellate Court considered such issue are as follows: In its opinion (R. 83), it said: "At the end of 1937 the bankrupt owed creditors, other than Budge, $4,913.15." However, the Court does not indicate that it knew all of that indebtedness had been contracted after July 1, 1937, which was the fact (R. 43), or if it were that such date had any significance. The Appellate Court says (R. 85), that the referee found that Budge had acted in good faith and that his acts and conduct should not be considered even constructively fraudulent as to other creditors. What the Court refers to appears in the referee's summary of the evidence in his certificate attached to the record on review before the District Court. The referee said there was no bad faith or fraud in connection with Budge's account with the corporation or the advances he made to the corporation (R. 57). The referee said nothing about creditors whose debts were contracted after July 1, 1937, and naturally he would not because in his Finding of Fact IX (R. 46) sup-

porting his order allowing the claim he found that the corporation used the money. Hence, he allowed the claim. The District Court did not consider the issue. The quotation from that Court's order (R. 85) speaks of the money being contributed in good faith to the corporation. The District Court said there was no such fraud as in *Pepper vs. Litton, supra.* The Appellate Court (R. 87) says: "The advances were made before the creditors to whose claims it is now contended Budge's claim should be subordinated, had become creditors." The Court clearly had in mind something that respondent had done before the debts were contracted, not his conduct or obligation in contracting the debts after July 1, 1937. That this petitioner urged this issue in the Appellate Court is apparent from the petition for rehearing (R. 94).

3.

It Is Not Discretionary With a Bankruptcy Court as to Whether or Not a Claim Shall Be Subordinated Where the Facts Are Undisputed and to Fail to Subordinate Such Claim Would Be Unfair or Inequitable as to Other Creditors.

We respectfully submit with all due respect for the opinion of the Appellate Court, that its failure to subordinate respondent's claim was erroneous. The Court apparently considered it was discretionary with the District Court as to whether respondent's claim should be subordinated to that of other creditors. The Appellate Court conceded that the lower court could have subordinated the claim on a finding that respondent's informal and irregular conduct of the affairs of the bankrupt had prejudiced creditors' rights and was a violation of respondent's duty to the creditors. There being no disputed question of fact, the failure of the Dis-

trict Court to make a finding did not prevent the Appellate Court from reversing the lower court and requiring it to subordinate respondent's claim.

Quinn vs. National Bank (C. C. A. 8), 32 F. (2d) 762, 763.

In fact, discretion does not extend to a refusal to apply well settled principles of law to a conceded or indisputable state of facts.

Peterson vs. John Hancock Mut. Life Ins. Co. (C. C. A. 8), 116 F. (2d) 148.

The motion for rehearing of the order of the District Court affirming the allowance of respondent's claim called for a judicial decision and not the exercise of any discretion since the facts were not in dispute.

Peterson vs. John Hancock Mut. Life Ins. Co., supra.

Respectfully submitted,

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BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The Findings and Conclusions of the Referee in Bankruptcy were filed April 11, 1940. (R. 44-47). The first opinion of the United States District Court for the District of Minnesota adopted the Findings and

Conclusions of the Referee and was filed December 31, 1940. (R. 70-71).

The second opinion on re-hearing before the United States District Court, District of Minnesota, was filed February 18, 1941. (R. 74).

The United States Circuit Court of Appeals, Eighth Circuit, filed an opinion on April 20, 1942, (R. 82) affirming the United States District Court and this opinion is reported in 127 Federal 2nd, Page 440.

A Petition for re-hearing was filed and denied on May 11, 1942. (R. 105).

JURISDICTION

The Petition for a Writ of Certiorari to the Circuit Court of Appeals, Eighth Circuit, was filed June 29, 1942.

The jurisdiction of this Court is invoked under Title 28, U. S. C., Section 347.

QUESTION PRESENTED

The case arises under the Federal Bankruptcy Act.

The question is whether the claim of a director and officer of a bankrupt corporation, for money loaned in good faith to the corporation and used by it in its corporate business, must be subordinated to the claims of general creditors which arose after the loans were made to and the money expended by the Corporation.

STATEMENT OF FACTS

The Petitioner is the Trustee of Liberty Poster Company, bankrupt, adjudicated as such on April 22, 1939. (R. 3). The matter was referred to Honorable Walter H. Newton, Referee in Bankruptcy, on the same date. (R. 3). The Trustee's Bond was approved May 17, 1939. (R. 3).

The Respondent, Budge, was an officer and director of the Company and owned one third of its stock. He filed a claim for salary for the years 1930, 1931 and for cash advanced between January 31, 1935, and April 20, 1937, in the total sum of $8,800.00 against which certain credits were acknowledged between November 1, 1930, and September 8, 1937, in the sum of $3,310.00 leaving a balance of $4,970.00 for which amount the claim was filed. (R. 10).

The Trustee objected to the claim on the grounds that the claimant, with two other shareholders, was engaged in a "joint venture or partnership" (R. 7), although operating under a corporate name; that all debts incurred after January 1, 1937, by the corporation were with "intent on the part of the bankrupt Rose, Budge and Morrissey of defrauding those persons" (R. 8) and that the money received by the corporation from Budge was a contribution to capital. (R. 8).

The Referee found that claimant was paid $2,060.00, which was accepted by him in full compensation of his salary aggregating $2,080.00 for the years 1930 and 1931, (R. 46) and $1,250.00 as part re-payment of sums advanced by him to the corporation, making the total credit of $3,310.00 and leaving a balance of $4,950.00 (R. 46); and that all of the cash advanced by the Respondent was paid to the corporation in good faith for its benefit. (R. 46).

The claim was allowed at $4,950.00.

On April 15, 1941, the Petitioner filed an application for review of the Referee's Order. (R. 47-53). The Referee's Certificate of Review, Findings and Order allowing the claim of the Respondent was filed May 2, 1940. (R. 53 to 61 inclusive). The good faith of the Respondent was admitted by the attorneys for the Trustee. (R. 57). The Referee attached to his Find-

ings a memorandum (R. 62) from which it clearly appears that, in reaching his conclusions, he closely scrutinized the good faith of the Respondent, any abuse of the fiduciary power of the Respondent, as an officer of the corporation, and the benefit received by the corporation from the advances made by the Respondent. (R. 62).

The District Court, in its opinion sustaining the Referee's Findings and upon consideration of the entire Record, (R. 70), found that the Referee had given consideration to all material facts presented before him; that the loan was openly made for the purpose of saving and not wrecking the corporation (R. 71) and that, although the corporate forms were disregarded, no substantial prejudice resulted to anyone and that nothing in the Record suggested "the history of a deliberate and carefully planned attempt" on the part of Budge to accomplish a fraud on creditors and allowed the claim of Budge and adopted the Findings and Conclusions of the Referee as its own.

On January 10, 1941, the Petitioner filed a Petition for re-hearing. (R. 71-74). This was heard on January 18, 1941, and denied on February 18, 1941. (R. 74).

Petitioner appealed to the United States Circuit Court of Appeals, Eighth Circuit, from the Order of the District Court, (R. 75-76), on April 20, 1942. The United States Circuit Court of Appeals, Eighth Circuit, filed its opinion, in which it held that "where a claimant is a person or corporation having complete ownership and control of a bankrupt corporation, which the claimant has organized, controlled and operated as a mere agent, adjunct or instrumentality for his own purposes and benefit, the courts will disregard the corporate entity at least so far as other creditors are concerned and deny to the alleged creditor participation

on a parity with them. (Cases cited) But, while the dealings of an officer, director or stockholder who files a claim against the bankrupt corporation for money loaned to it will be subjected to rigorous scrutiny and the claimant required to prove the good faith of the transaction upon which the claim is based and also its fairness from the point of view of the corporation and those interested in it (*Geddes* v. *Anaconda Copper Mining Co.,* 254 U. S. 590, 599; *Pepper* v. *Litton,* 308 U. S. 295, 306), his relation to the bankrupt will not prevent the allowance of his claim on a parity with other creditors if he can show that the money was needed by the corporation and was used for proper corporate purposes and that the transaction between him and the corporation was open, honest and free from unfairness or fault." (Cases cited) (R. 87). The Court further held that it was the duty and responsibility of the bankruptcy court to determine whether, under the applicable law, the claim of Budge was upon an equitable parity with the claim of other creditors. (R. 87).

The order of the District Court was affirmed with costs. (R. 92).

On May 4, 1942, the Petitioner made application for a re-hearing. (R. 93-104). This was denied on May 11, 1942. (R. 105).

On May 28, 1942, an application for stay of mandate was filed (R. 105) and the Order staying the issuance of the mandate was filed May 29, 1942. (R. 107).

On June 29, 1942, the Trustee filed a Petition for a Writ of Certiorari to the United States Circuit Court of Appeals, Eighth Circuit, together with his supporting Brief and Record.

ARGUMENT

I. The proposition urged by Petitioner may be stated as follows:

The claim of one interested in the business and management of a corporation for money advanced in good faith in an effort to keep it solvent must be subordinated to the claims of future general creditors of the Corporation.

This proposition penalizes every honest attempt of a stockholder, officer or director to keep a corporation in business by advancing his own money to it. No authority for this unusual and inequitable contention is cited. The cases upon which petitioner relies (*Pepper* v. *Litton,* 308 U. S. 295; *Peterson* v. *John Hancock Mutual Life Insurance Company,* 116 F. (2d) 148; *Quinn* v. *National Bank,* 32 F. (2d) 762; *Sampsell* v. *Imperial Paper & Color Corporation,* 313 U. S. 215; *Taylor* v. *Standard Gas & Electric Company,* 306 U. S. 307) state no such doctrine. Where they enforce subordination it is because of a lack of good faith by those in control of a corporation, a misuse of corporate opportunity, discrimination for the benefit of insiders, or some other breach of a fiduciary duty owed. In the present case Petitioner not only does not deny the good faith of Respondent but has admitted it. (R. 57).

The question thus presented is a narrow one and completely disposed of by the finding and admission of Respondent's good faith. A proper statement of the rule applicable here appears in *Arnold* v. *Phillips,* 117 F. (2) 497, 503: "That the lender dominates the corporation opens the transaction to closer examination; it does not ipso facto invalidate it. We find here no proof of mala fides, or that the money was not fully paid to and used by the corporation in an honest effort to carry on its own business."

The Respondent was required to assume and did assume the burden of proof, not only of the amount of his claim but also of his good faith. (R. 62-63). More is not required of him.

The Referee, in his memorandum, indicated clearly that the rule laid down in the *Arnold* v. *Phillips* case was followed, as appears from his statement "to insure this fairness and to avoid any abuse of the fiduciary powers of such an official, transactions of this character should be most closely scrutinized," (R. 62), resting his decision within the rule as laid down in *Pepper* v. *Litton,* 308 U. S. 295, 306, and *Geddes* v. *Anaconda Copper Mining Co.,* 254 U. S. 590, 599.

The United States District Court held the controlling features of the case to be the conceded good faith of the respondent and benefit to the corporation, (R. 71), basing its opinion within the rule laid down by the Circuit Court of Appeals in this case, (R. 87), and in accordance with the rule laid down by this Court in *Geddes* v. *Anaconda Copper Mining Co.* and *Pepper* v. *Litton, supra.*

Therefore, it appears that there is no basis upon which the Petitioner can justify a complaint that there is a conflict here between the decisions of the lower Courts and the opinions of this Court.

II. The second complaint of the Petitioner is that the issues between the Respondent and creditors, whose claims arose after July 1, 1937, were not considered by the Court. The issue was before the Referee. (R. 43 and 52). It was considered by the Referee in his summary of evidence, (R. 58), wherein he stated "No evidence whatever was presented that any creditor was (mislead) by any representation from Budge or any other officer as to the transactions mentioned in the account. Everything was in the utmost good faith." (R. 58).

It was again referred to in the Petitioner's application for a review, (R. 66), and considered by the United States District Court who "considered the entire record." (R. 70). It was again directed to the attention of the Court by Petitioner in his application for rehearing, (R. 72), and considered by the United States District Court on re-hearing. (R. 74).

The Circuit Court of Appeals in its opinion, considered the rights of creditors, whose claims were created after July 1, 1937, saying: "The evidence does not justify an inference that Budge manipulated the affairs of the corporation for his own personal advantage. The inference which is justified by the evidence is that the advances which Budge made were made in good faith to enable the bankrupt to meet pressing obligations and to remain in business. The advances were made before the creditors, to whose claims it is now contended Budge's claim should be subordinated, had become creditors." (R. 86 and 87).

On this point, the Petitioner confuses his failure to prevail after full consideration with the denial of a substantial procedural right. No such denial exists in this case.

CONCLUSION

The Respondent is equitably entitled to parity with general creditors of the bankrupt corporation. The Referee and the Trial Court so held and the Circuit Court of Appeals found no reason to reverse. The petition in this case presents no substantial question for review and should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1942

No. 189

FRANK A. BARLOW, TRUSTEE OF THE ESTATE OF THE LIBERTY POSTER COMPANY, A CORPORATION, BANKRUPT, *Petitioner,*

vs.

W. P. BUDGE, CLAIMANT,

Respondent.

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

POSITION OF RESPONDENT

Respondent claims the issue before the Bankruptcy Court was whether his claim for money loaned in good faith to and used by the corporation must be subordinated to the claims of the general creditors which arose thereafter. This position ignores the duty and obligation that respondent owed to the creditors whose claims were contracted after July 1, 1937, and after respondent was unwilling to make further contributions. Respondent relies on two points: One, that the contributions constituted a loan, and the other, good faith.

LOAN

Whether the contributions by respondent constituted a loan, or amounted to a contribution to capital is not decisive of this case, because of the duty the respondent owed to the creditors whose claims were contracted after July, 1937. At the time that the contributions were made, the capital was inadequate and the corporation could not then have borrowed from informed outside sources. The contributions were made to keep the business going. If the business had been liquidated at that time, the debts of the present general creditors would never have been contracted. The record required a disallowance of the claim of respondent because the contributions were to capital and not a loan. The most that can be said for respondent is that when he made the contributions he intended, at some future time, to make withdrawals from the corporation, as he had previously done. That is, as between himself, Rose and Morrissey, he, like a partner, or joint venturer, would withdraw such contributions. The time never came when he could make such withdrawals without causing the liquidation of the corporation. The respondent and Rose treated the corporate business as their own enterprise. This alone was sufficient to require the subordination of respondent's claim to that of the creditors whose debts were contracted after July 1, 1937. *Pepper vs. Litton*, 308 U. S. 295, 310.

GOOD FAITH

There was no admission of respondent's good faith. The portion of the Record that respondent refers to appears in the referee's summary and was not sustained by what actually took place before the referee. At page 39 of the Record appears the whole of what took place in this connection and is as follows:

"The Referee: Now, is there any question of facts here involved—that Mr. Budge actually, in the manner indicated, contributed or paid over these amounts?

Mr. Culhane: I don't think there is any question but what he turned the money over to the corporation.

The Referee: And that it was used for corporate purposes?

Mr. Culhane: I think it was.

The Referee: Then practically the only question here is, the question of law as to whether on the facts as presented, there was a contribution of capital, not permitting him to share with the general unsecured creditors, or whether he shares with them as a debtor; is that it?

(Argument by counsel.)

The Referee: Both sides have tentatively rested in the Budge matter.

Mr. Culhane: That is right."

Considered as a loan the Record shows not only bad faith but actual fraud as to creditors whose claims were contracted after July 1, 1937. By that date, as a result of continual losses over a term of years and very substantial withdrawals from the corporate capital, even after the corporate capital had been depleted (R. 18, 21), the respondent was unwilling to make any further contributions. However, he and Rose, after that date, contracted substantial debts with general creditors, still unpaid.

CREDITORS MISLED

Respondent urges that creditors were not misled by what he did. The evidence as to whether this is true or false is not in dispute. The Circuit Court of Appeals said: That the advances made by respondent were made to enable the corporation to meet pressing obligations and remain in business (R. 87). Respondent testified that the contributions were made to prevent the bank account from being overdrawn (R. 24-26) and save the corporation from financial

difficulty (R. 38). The threatened financial difficulty was occasioned by losses over a period of years and unauthorized withdrawals (R. 18, 21). The capital stock had been substantially depleted by July 1, 1937, if respondent's claim was then an actual debt of the corporation and not a capital contribution (R. 21). To all outward appearances on and after July 1, 1937, those selling to the corporation were justified in believing that the corporate capital had not been depleted and in extending credit accordingly. As to creditors' justification for relying on professed capital in extending credit, the Supreme Court of Minnesota in an opinion by Justice Mitchell in *Hospes vs. Northwestern Manufacturing & Car Co.*, 48 Minn. 192, 50 N. W. 1117, 15 L. R. A. 470, 31 Am. St. Rep. 637, cited in the Petition for Re-hearing herein, in a case by creditors to compel holders to pay for "bonus" stock, said in part:

> "It is urged, however, that, if fraud be the basis of stockholders' liability in such cases, the creditor should affirmatively allege that he believed that the 'bonus stock' had been paid for, and represented so much actual capital, and that he gave credit to the incorporation on the faith of it; and it is also argued that, while there may be a presumption to that effect in the case of a subsequent creditor, this is a mere presumption of fact, and that in pleadings no presumption of facts are indulged in. This position is very plausible, and at first sight would seem to have much force; but we think it is unsound. Certainly, any such rule of pleading or proof would work very inequitably in practice. Inasmuch as the capital of a corporation is the basis of its credit, its financial standing and reputation in the community has its source in, and is founded upon, the amount of its professed and supposed capital, and everyone who deals with it does so upon the faith of that standing and reputation, although, as a matter of fact, he may have no personal knowledge of the amount of its professed capital, and in a majority of cases knows nothing about the shares of stock held by any particular stockholder, or, if so, what was paid for them."

CONTRIBUTIONS WERE MADE BEFORE JULY 1, 1937

Respondent relies upon the language of the Circuit Court of Appeals that: "The advances were made before the creditors, to whose claims it is now contended Budge's claim should be subordinated, had become creditors" (R. 86-87). This statement shows that the Circuit Court of Appeals did not consider the fiduciary obligation that respondent owed to creditors whose debts were contracted after July 1, 1937. This question is covered in our former brief in connection with Reason 2. The case at bar falls within a class of corporate cases, sometimes called "claims cases." The decisions of the courts in such cases are in a state of some confusion and conflict. In *Deep Rock, Pepper vs. Litton* and *Sampsell* cases, we submit that this court, for the guidance of Courts of Bankruptcy, pointed out basic equitable principles applicable in cases like the case at bar. With all due respect for the Honorable Judges of the Circuit Court of Appeals for the Eighth Circuit, the equitable principles, above referred to, were not applied in the case at bar. On the contrary, the judgment of that court conflicts with these equitable principles and unless such judgment is reviewed by this court, it and the opinion of the Circuit Court of Appeals, will tend to cause further confusion and conflict in the decision of Courts of Bankruptcy as to the application of the above mentioned equitable principles in cases similar to the case at bar.

Respectfully submitted,

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